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Dynamic Analysis of Republican Tax Policies

Executive Summary

- The Department of Treasury's report, "A Dynamic Analysis of Permanent Extension of the President's Tax Relief," was issued in July, and is the first public attempt by the department to perform a dynamic analysis of any major piece of legislation – in this case, the President's proposal to make permanent the 2001 and 2003 Republican tax policies.
- According to the Treasury report, "Dynamic analysis provides a more comprehensive and complete approach to analyzing tax policy by including its effects on the overall size of the economy and other major macroeconomic variables."
- The Treasury report reveals extensive information, but there are three primary lessons to note:
    - Lower tax rates lead to economic growth.
    - All tax relief is not created equal.
    - It matters how tax relief is paid for.
- Although debate resonates among economists and tax professionals alike regarding the efficacy of tax cuts, the Treasury report supports the claim that the Republican tax relief has a *positive* effect on the economy.
- The findings reveal that the tax relief would increase Gross National Product (GNP) by 0.7 percent in the long run. This means that in a $13 trillion economy, we would see a $90 billion increase in our economy *each year*.
- Tax relief encourages people to save more, work more, and invest more by reducing the distorting effects of taxes.
- The findings reveal that the economy is stronger in the long run if the tax provisions are made permanent and are accompanied by lower future government spending. Conversely, the economy suffers if the permanent tax provisions are financed by future higher taxes.
- The President's FY 2007 budget includes a plan to create a division within the Office of Tax Analysis (OTA) at the Treasury Department devoted to dynamic analysis.

Introduction

The Department of Treasury's report, "A Dynamic Analysis of Permanent Extension of the President's Tax Relief," was issued in July, and is the first public attempt by the department to perform a dynamic analysis of any major piece of legislation – in this case, the President's proposal to make permanent the 2001 and 2003 Republican tax policies.[1] The initial finding serves as a positive step towards understanding how tax relief functions as a component of economic health, and it deserves attention. According to the Treasury report, "Dynamic analysis provides a more comprehensive and complete approach to analyzing tax policy by including its effects on the overall size of the economy and other major macroeconomic variables."[2]

This paper does *not* attempt to delve into a policy debate about the merits of dynamic scoring; rather, it highlights the Treasury's dynamic analysis findings and discusses the additional dynamic analysis efforts that can be made. From the outset, it is important to distinguish between the two terms. Dynamic analysis involves accounting for changes in various macroeconomic factors such as capital accumulation, labor force participation, private consumption, and investment when examining how certain policy initiatives affect budgetary outcomes; whereas, dynamic scoring examines these same effects on the economy but takes the analysis one step further by looking at possible tax revenues.

Report Reveals Relationship Between Tax Relief & Economic Growth

The Treasury report separately analyzes the effects of three groups of tax-relief provisions, all of which are currently set to expire at the end of 2010, unless made permanent: (1) permanent extension of lower capital gains and dividends tax rates; (2) permanent extension of individual income tax rates – 25-, 28-, 33-, and 35-percent – and a permanent extension of the repeal of the phase-out of personal exemptions and itemized deductions; and (3) permanent extension of the increase in the child credit from $500 to $1,000 per child, the increased standard deduction for joint filers, and the 10-percent rate bracket.[3] Although the Treasury report reveals

[1] Department of Treasury, Office of Tax Analysis, *A Dynamic Analysis of Permanent Extension of the President's Tax Relief*, July 25, 2006, at http://www.treasury.gov/press/releases/reports/treasurydynamicanalysisreporjjuly252006.pdf (hereinafter Treasury Report). The analysis was also summarized in a box included in the Administration's Mid-Session Review released July 11, 2006. The provisions set to expire at the end of 2010 include lower tax rates on ordinary income, lower tax rates on dividends and capital gains, a 10-percent individual income tax bracket; doubling of the child tax credit, and reducing marriage penalties.

[2] Treasury Report. "The purpose of the report is to provide a more in-depth, transparent understanding of dynamic analysis, while also illustrating the positive contributions that tax relief, together with spending reductions, can be expected to continue to make to the U.S. economy. In addition, the analysis shows the importance of making the tax provisions permanent for the U.S. economy's long-term economic growth."

[3] The Treasury Report does not take into account the permanent repeal of the estate tax; rather, it assumes that the estate tax phases out in 2010 and reverts to its pre-2001 levels. The Treasury Department used a model for its analysis known as the overlapping generations ("OLG") general equilibrium model. The OLG takes into account the effects of work effort, increases in savings and investments, and improved allocation of resources on the size of

extensive information, there are three primary lessons to note:

- ❖ Lower tax rates lead to economic growth.[4]
- ❖ All tax relief is not created equal.
- ❖ It matters how tax relief is paid for.

Lower Tax Rates Lead to Economic Growth

Although debate resonates among economists and tax professionals alike regarding the efficacy of tax cuts, the Treasury report supports the claim that the Republican tax relief has a *positive* effect on the economy.[5] The findings reveal that the tax relief would increase Gross National Product (GNP) by 0.7 percent in the long run.[6] "This means that in a $13 trillion economy, we would see a $90 billion increase in our economy, *each year*, forever."[7] Tax relief encourages people to save more, work more, and invest more by reducing the distorting effects of taxes.[8] The relief affects economic behavior and decision-making, which in turn affects the economy in a very positive way, according to the report:

> Lower tax rates enable workers to keep more of their earnings, which increases work effort and labor force participation. The lower tax rates also enable innovative and risk-taking entrepreneurs to keep more of what they earn, which further encourages their entrepreneurial activity. The lower tax rates on dividends

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the economy. While these variables were useful in the analysis, the OLG model does have its limitations. Namely, various aspects of economic behavior are not included, such as the cyclical disruptions in the employment of capital and labor. Rather, the OLG model assumes that *all* resources in the economy are *always* fully employed. By pointing out these limitations in the report, it can serve to encourage the improvement of existing models and the development of new ones to ensure more complete analysis based on all of the relevant economic indicators.

[4] Economists continue to debate the magnitude of the effect on economic growth.

[5] Treasury Report. A previous report issued by the Treasury is that without enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001, the Job Creation and Worker Assistance Act of 2003, and the Jobs and Growth Tax Relief Reconciliation Act of 2003: (1) by the second quarter of 2003, the economy would have created as many as 1.5 million fewer jobs and GDP would have been as much as 2 percent lower, and (2) by the end of 2004, the economy would have created as many as 3 million fewer job and real GDP would be as much as 3.5 to 4.0 percent lower.

[6] GNP is also known as annual output and/or national income.

[7] Robert Carroll, Deputy Assistant Secretary for Tax Analysis, Department of the Treasury, remarks before the National Economists Club, July 27, 2006 (hereinafter Carroll Remarks).

[8] According to Martin Feldstein, professor of economics at Harvard University and president and chief executive officer of the National Bureau of Economic Research, remarks at the U.S. Treasury, March 14, 2006, "there are a variety of specific distortions that come about because of the structure of capital income taxation: the allocation of capital between corporate and non-corporate forms of business, the decision of companies to pay dividends or to retain earnings, the mix of debt and equity finance, the realization of capital gains, and the location of businesses in the United States and abroad. The tax structure affects each of these decisions in ways that cause deadweight losses."

and capital gains lower the cost of equity capital and reduce the tax biases against dividend payment, equity finance, and investment in the corporate sector.[9]

All Tax Relief is Not Created Equal

While some tax rate reductions affect economic growth in a positive, pro-growth manner, others have virtually no effect in the long term. The Treasury report examines the three abovementioned tax category provisions using three different scenarios and found that, ultimately, permanent marginal rate cuts produce the greatest economic gains.

<u>Scenario One Analysis</u>: permanently extending just the lower tax rates on dividends and capital gains increases GNP in the long run by 0.4 percent. This particular result is very telling, because, although the lower rates on dividends and capital gains make up less than 20 percent of the revenue loss from permanent tax relief, they produce *more than half* of the long-run growth, according to the report.

<u>Scenario Two Analysis</u>: permanently extending the lower tax rates on dividends and capital gains as well as the lower tax rates for the top four income-tax brackets increases GNP in the long term by 1.1 percent.

<u>Scenario Three Analysis</u>: permanently extending the lower tax rates on dividends and capital gains, the lower tax rates for the top four income-tax brackets, and the increased child credit amount, marriage-penalty relief, and the 10-percent rate bracket increases GNP in the long term by 0.7 percent. Although the child tax credit, the marriage-penalty relief, and the 10-percent rate bracket did not necessarily increase long-term growth, the provisions did perform a needed function: stimulate the economy in the *short-term*.[10]

It is important to recognize that a balanced package of tax provisions that takes into account both short-term and long-term growth can be quite successful. According to remarks by Robert Carroll, Deputy Assistant Secretary for Tax Analysis at the Department of Treasury:

> In looking back at the 2001 and 2003 tax relief, it is crucial to remember that the broad policy objectives were two-fold: (1) to shore up and strengthen an economy that faced significant risks – a double-dip recession, disinflation; and (2) to promote long-run growth. The package of policies accomplished those twin goals by accelerating the rate at which the economy returned to full capacity and … promoting long-term growth.[11]

The Treasury report reveals that, although various tax provisions may be enacted in a comprehensive package, their effects on the economy can vary dramatically. This explains the differences between the abovementioned scenarios. The Treasury report shows that reducing

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[9] Treasury Report.
[10] In addition, the 10-percent tax category makes the tax system more progressive.
[11] Carroll Remarks.

taxes on marginal tax rates on capital gains, dividend income, and ordinary income (*see* Scenario Two Analysis) produces larger economic gains than permanently extending both of the lower marginal rates as well as the 10-percent tax bracket, the child tax credit, and marriage penalty relief (*see* Scenarios Three Analysis). These types of discoveries serve as invaluable information for future tax legislation because they afford lawmakers the ability to distinguish those provisions that increase long-term gain from those that stimulate the economy only in the short-run.

It Matters How Tax Relief is Paid For

A key feature of the Treasury report is that it recognizes that the government faces an "intertemporal budget constraint."[12] In basic terms, this means that when tax rates are reduced, other offsetting changes are mandatory in order to avoid an immediate increase in the deficit.[13] Therefore, how the government finances tax cuts is crucial. The two financing options that the Treasury Report considered are lower future government spending and higher future taxes. The findings reveal that the economy is stronger in the long run if the 2001 and 2003 tax provisions are made permanent and are accompanied by lower future government spending. Conversely, the economy suffers if the permanent tax provisions are financed by future higher taxes. Long-run output would decline as future tax rates increase – the economy would likely experience a decline in labor supply (0.8 percent), a decline in capital (1.8 percent), and a decline in GNP (0.9 percent). Thus, in order to fully gain the economic growth estimated in the Treasury report, the optimum course of action *must* be to reign in government spending.[14]

More Dynamic Analysis is Needed

The President's FY 2007 budget includes a plan to create a division within the Office of Tax Analysis (OTA) at the Treasury Department devoted to dynamic analysis. Conventional revenue estimating can vary substantially from dynamic estimating because, although conventional revenue estimating often includes some microeconomic behavioral effects, such as income recognition and the timing of transactions, it does not include economy-wide macroeconomic effects. A permanent dynamic division would enable the Treasury Department to complement its current conventional revenue estimates with dynamic ones, establishing a more comprehensive system for reviewing tax proposals. The President's proposal has been incorporated into both the House and Senate FY07 appropriations bills, which are awaiting final action.

The Joint Committee on Taxation (JCT) and Congressional Budget Office (CBO) also have taken steps to introduce more dynamic analysis in their examinations of tax policies. Their future efforts could include developing their macroeconomic abilities and making more of their

[12] Treasury Report.
[13] Treasury Report.
[14] The Bush Administration proposed to make the tax relief permanent ***and*** to reduce spending in his FY 07 budget.

findings public.[15] A proposed dynamic analysis office at the Treasury is a positive step towards more systematic dynamic analysis and will likely help to encourage JCT and CBO to use dynamic analysis in a more frequent and transparent manner.

Conclusion

The current goal, as evidenced by the Treasury report, is to utilize models that accurately assess the effects of tax legislation on the economy – dynamic analysis. The ultimate goal should be to develop models that can make the natural transition to the next step by determining the resulting tax revenue that tax proposals will produce for the government – dynamic scoring. This may be particularly valuable should Congress consider fundamental tax reform. The Treasury report, in tandem with the President's proposed dynamic analysis office, symbolizes the first steps toward a more balanced and realistic understanding of tax policy.

[15] At present, JCT and CBO only supplement official estimates using macroeconomic feedback effects. These are oftentimes not made public, lack uniform model and behavioral specifications, and keep aggregate output fixed. See, for example, CBO, *An Analysis of the President's Budgetary Proposals for Fiscal Year 2007*, 2006, http://www.cbo.gov/ftpdocs/70xx/doc7069/03-14-presidentsbudget.pdf and JCT, *Exploring Issues in the Development of Macroeconomic Models for Use in Tax Policy Analysis*, 2006.